



Controller's Quarterly

California Economic Challenges

Kathleen Connell, California State Controller

August 1997

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Message From State Controller Kathleen Connell

I am pleased to present the eighth issue of *Controller's Quarterly*. In this issue, we focus on the relationship between state government in California and local governments. Our purpose is to examine the tax structure as it has evolved since passage of Proposition 13, approved by California voters in June 1978, to slow the rise in property taxes.

In our overview article, we recommend reassessing California's tax structure. It is imperative that the State provide local governments with the financial resources they need to carry out the responsibilities they now have. With the trend toward downshifting program responsibility to the local level, there needs to be a transfer of funding as well. Currently, local government budgets are strained to the breaking point as they attempt to meet the requirements of national and state-mandated programs without sufficient resources.

Our guest authors on this topic represent the State, local governments, and academic perspectives. They include a review of financing strategies local governments have employed to replace lost property tax revenues and examine the potential impact on cities of Proposition 218, approved by voters this past November. Among its provisions, Proposition 218 requires voter approval before cities can use some of the financing tools that have become common in the two decades following Proposition 13's passage.

This issue of the *Quarterly* also offers a profile of California's Central Valley. As described by our guest author, the Valley is in transition from one of the world's leading agribusiness regions to an increasingly diverse economy. Its products range from semiconductors and computers to farm products and wine.

On the economic front, I am pleased to report that California's economy continues on its strong course. We are experiencing healthy job growth, particularly in construction, reduced unemployment, and increased home sales. California also has seen very strong income growth, which has generated over \$3 billion more in tax revenues to the State compared to last year. All signs indicate that 1997 will be another strong year for the economy with increased opportunities for Californians.

KATHLEEN CONNELL
Controller
State of California

August 1997

California Economy

Controller's Outlook

The National Outlook

Sustained by plentiful jobs, robust exports, and low inflation, the current U.S. economy is a dream come true. Consumer confidence remains high, corporate profits are at record levels, and the federal budget deficit seems to be fading away. In the first quarter of this year, the Gross Domestic Product (GDP) grew at a strong 4.9%. In the second quarter, stronger than expected exports may cause GDP to be revised upward from an initial estimate of 2.2% to over 3%. Despite the anxiety of stock and bond traders over the possibility of an interest rate hike by the Federal Reserve to slow this growth, it is unlikely that a rate hike of the size economists expect (about 1%) would trigger a recession.

For the past four months, the national unemployment rate has hovered in the range of 4.8% to 5%, with no sign of inflation. The producer price index has, in fact, declined for the past seven months. Assuming that interest rates are raised over the next year, national unemployment rates of roughly 6% are possible by 1998. Ironically, a slight rise in the nation's unemployment rate would probably benefit California; a national unemployment rate at or

above California's usually results in migration to the state from the rest of the nation. This in turn stimulates the state's housing market.

The California Outlook

Strong job growth continues to propel California's economy. The Controller's Council of Economic Advisors is projecting California's employment gains to rise to 3.1% for 1997.

The unemployment rate in California declined to 6.1% in July, a full percentage point lower than last year in the same month. The Council anticipates that unemployment in 1997 will average 6.5%.

Labor force growth was relatively slow in 1996, increasing by only 1.8%. Labor force participation rates in California slipped below na-

tional rates during the recession but have started to rise. In May, labor force participation of persons age 16 and older reached 66%, up from 65% one year ago. Nationally, the rate was 67% in May 1997.

The Council's outlook for personal income in California is very optimistic, due in part to the high labor force participation rate that contributes to personal income growth. The Council is projecting a 7.2% rise in personal income this year, up from 6.7% in 1996. The higher rate of growth should boost State revenues and stimulate the housing market. However, rising interest rates are likely to moderate the stimulus, especially for residential construction. The Council expects residential construction will total 109,000 units in 1997.

"Strong job growth continues to propel California's economy. The Controller's Council of Economic Advisors is projecting California's employment gains to rise to 3.1% for 1997."

Figure 1

1997 Forecast by Controller's Council of Economic Advisors

Council Member	Employment Growth (Annual %)	Unemployment (Annual %)	Personal Income Growth (Annual %)	Res. Building Permits (Thou)
LA Economic Devt. Corp. (J. Kyser)	2.9%	6.4%	6.4%	106
Calif. Assn. of Realtors (G.U. Krueger)	3.8%	6.6%	9.8%	120
UCLA, Business Forecasting Project (L. Kimbell)	3.7%	6.4%	8.3%	108
UC Berkeley, Center for Real Estate & Urban Economics (C. Kroll)	3.0%	6.2%	7.0%	105
Bank of America (J.O. Wilson)	2.7%	6.7%	6.3%	105
Pacific Gas & Electric (T. Munroe)	2.7%	6.4%	6.3%	111
ARCO (A. Finizza)	3.2%	6.5%	6.5%	110
Mean	3.1%	6.5%	7.2%	109
Median	3.0%	6.4%	6.5%	108
State Controller	3.0%	6.4%	6.7%	108
1996 Actual*	2.8%	7.3%	6.7%	94

* "Actual" figures may vary from prior published figures to reflect new data that has become available.

Source: State Controller's Office; Council of Economic Advisors

"Tax receipts on personal income confirm that there has been very strong income growth in California over the past year... Tax revenues this year are up more than \$3 billion over last year."

Figure 2

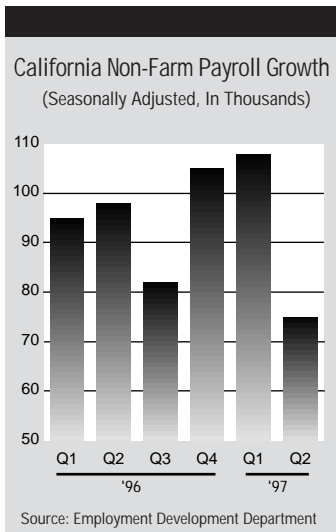
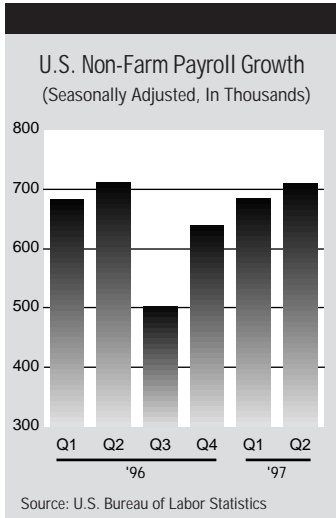


Figure 3



Employment

The highest rate of employment growth over the past year occurred in construction jobs, where the annual rate of increase from July 1996 to July 1997 was 9.5%. The next strongest growth occurred in service jobs, which increased by 4.2% during this period. Employment in the FIRE sector (Finance, Insurance, and Real Estate) continued to show weakness, as did retail trade jobs. Figures 2 and 3 compare non-farm payroll growth in California and the U.S., respectively, for the past six quarters. Employment growth both in the U.S. and California has been strong over the past 18 months. While California's second-quarter growth dipped from the first quarter, third-quarter growth is expected to rebound.

Regionally, the economic expansion remains uneven. Los Angeles is still in the recovery phase; Santa Clara County is booming. Los Angeles is 8% below the peak employment levels seen in 1990, while Santa Clara is 8% above the 1990 levels. The most recent labor force data (July 1997) indicates that unemployment in Los Angeles was 6.6%. The decline in the unemployment rate in Los Angeles, however, has been driven as much by slow growth in the labor force as by an increase in the number of jobs.

Real Estate

Home prices in Califor-

nia are rising over a broad area. In the San Francisco Bay Area, excluding Santa Clara County, prices increased 6.9% in the second quarter of 1997 over the prior year. In Santa Clara County, second-quarter prices were up by almost 13% over the previous year. San Diego and Orange counties saw price increases of 5.7% and 6.2%, respectively. This rise in prices undoubtedly was related to a sharp decline in the number of foreclosures, especially in Southern California. Dataquick reported that foreclosures were down 21.3% in March compared to a year ago. March was the fourth month in which foreclosures declined. In Los Angeles, where foreclosures have been concentrated, March saw a decline of 29% over the previous year.

Residential Construction

Despite the strong economic growth that California has experienced, housing construction is having difficulty developing momentum on a statewide basis. During the first six months of 1997, the annualized rate of building was roughly 106,000 units, lower than expectations of a few months ago.

Residential construction in the Bay Area is up by almost 22% in the first six months over the same period last year. Statewide, residential construction has increased 9.6%. Southern California, especially San Diego, Riverside-San Bernardino,

and Orange counties, is doing well. In Palo Alto, San Francisco, and San Jose, vacancy rates are extremely low and prices are rising rapidly. Many parts of the Bay Area are reporting vacancy rates of less than 2%. Home prices in Santa Clara County had the highest appreciation of any U.S. county during the second quarter of 1997. Even rising interest rates probably will not dampen that market.

The Bay Area's commercial real estate sector is even more robust than its residential market. The dollar value of office construction in the Bay Area is up nearly 575% in the first six months of 1997. More than 60% of office construction in California is now occurring in the Bay Area. Given the Silicon Valley's rate of job expansion, this trend can be expected to continue.

Personal Income

Tax receipts on personal income confirm that there has been very strong income growth in California over the past year. The UCLA Business Forecast estimates personal income growth was 6.7% in 1996. While job growth certainly has contributed to this strong showing, it is non-wage income (proprietor's income, dividends, and rents) that is setting the pace. This has been good not only for the people of California but for the State as well. Tax revenues this year are up more than \$3 billion over last year.

Reassessing California's Tax Structure

Two Decades After Proposition 13

When Proposition 13 was overwhelmingly approved by California voters in 1978, it did more than put a stop to rapidly escalating property taxes. It fundamentally altered the relationship between government at the state and local levels. Property tax revenues and rates previously governed at the local level came under the control of the State, restricting the ability of local governments to respond to changed economic circumstances in their communities. The voter-imposed cap on these taxes resulted in significantly reduced revenues to fund local public programs and services. In addition, tax equity among counties became an issue as some counties ended up contributing a higher proportion of tax revenues to the State than is returned in services.

Efforts by policy makers to deal with the new tax structure brought about by Prop. 13 have met with mixed success. Today, nearly 20 years after Prop. 13 was passed, many local governments are still struggling to make up for the lost revenue. As a consequence, many non-mandated programs have been dropped from local budgets. Fiscal uncertainty has been compounded by reversals in the State's allocation of property tax rev-

enues to counties, cities, and special districts. This occurred during the recession of the early '90s when, in order to balance its own budget, the State shifted property tax revenues away from local governments to schools. Lacking the authority to raise tax rates, or to impose special taxes without two-thirds approval of their voters, local governments, particularly counties, have been hit hard.

While it remains unlikely that Prop. 13 will be repealed, increasingly there are calls for changes in the tax structure that has evolved since its passage. As demonstrated by the recent overhaul of the welfare system, more and more program responsibility is shifting from the federal government to states, and from states to local governments. These shifts have highlighted weaknesses in the current tax structure. The revenue sources to fund many programs have not accompanied the transfer of responsibility. The result is that taxpayers are left wondering who is accountable for ensuring these programs are adequately funded and whether their tax dollars are actually being spent in the most appropriate manner. In short, the time has come to reassess California's tax structure.

Retracing Prop. 13's Impact

State government receives none of its income from the property tax, but Prop. 13 decreed that the State was to allocate property tax revenues among local jurisdictions. Since many of the services provided at the local level are mandated by the State, it was necessary for the State to provide a higher level of support for those services. In 1980, the Legislature passed Assembly Bill 8, known as the "bailout" legislation. AB 8 realigned programs and funding among levels of government to accommodate revenue losses due to Prop. 13. A major feature of AB 8 was the transfer of property tax revenues from schools to counties, cities, and special districts. In addition, the State assumed a larger role in financing health and welfare programs.

AB 8 had the negative effect of locking in a formula for allocating property tax revenues to counties based on tax rates that existed prior to passage of Prop. 13. While this did not affect school funding — the State made up for the amount schools lost from property taxes on a dollar-for-dollar basis — it did affect counties' non-school funding. After Prop. 13's passage, the State's allocation of property tax rev-

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enues for counties' non-school programs was based on the individual counties' tax rates. Counties that had relatively low tax rates prior to Prop. 13 received a lower percentage of the post-Prop. 13 revenues than counties that had higher tax rates. Over time, this has developed into a situation in which "donor" counties contribute a larger share of the State's revenues than "recipient" counties, yet receive a lower share for funding their non-school programs and services.

In the first few years after Prop. 13 passed, most local governments found they could cope with the new fiscal regime, even though they were severely limited in their ability to raise new funds. While some cuts were necessary at the local level, the State was running a budget surplus in those years and could provide assistance to weather emergencies. However, in 1981-82, California suffered a recession and the budget surplus disappeared. The State responded by re-

ducing subventions to local governments. This was a harbinger of changes to come.

The recession of 1982-83 was mild compared to the recession that began in California in 1990. After an economic boom in the late 1980s, the economy began to contract sharply in 1990. In 1991, the State faced severe budgetary problems. Deficits were a constant threat. Between 1991-92 and 1993-94, the State faced the possibility of annual budget deficits between \$4 billion and \$14 billion unless dramatic actions were taken. Taxes were raised and programs were reduced. Most important to local governments was the initiation of "realignment." Realignment produced substantial changes in state/local cost sharing for programs such as welfare and health programs. In 1991, more of the costs for county health services and community mental health services were shifted to the counties along with additional sales tax and vehicle license fee revenues to fund the portion that was formerly paid by the State. In addition, in 1992 the State transferred \$3.8 billion of local property tax revenues to school districts from cities, counties, and special districts. These transfers occurred in stages through 1993-94.

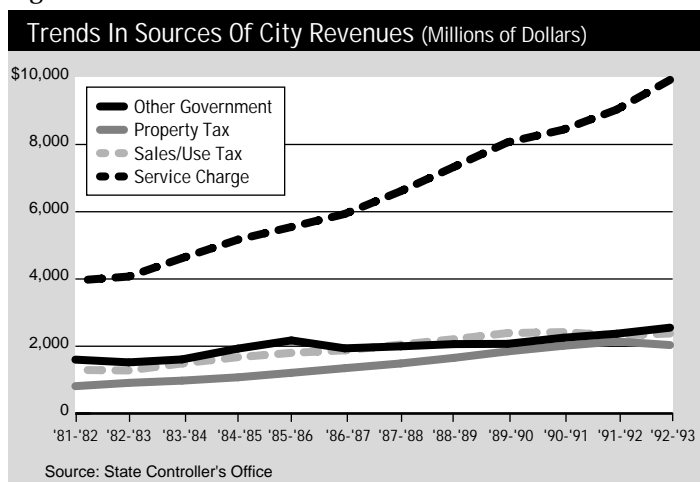
County Budgets Affected Most

The impact of the changes that began with Prop. 13 has been felt the

most by county governments. This is due in part to the nature of the services provided at this level of government — they tend not to be revenue-generating. Cities provide services that, in some cases, generate a fee. These include utilities, sewers, trash collection, zoning and planning, business licenses, parking, fire and ambulance. Cities generally have pursued this option to resolve their funding problems. As shown in Figure 1, this had been a successful strategy for cities, but that could change with voter approval in November 1996 of Proposition 218. (See "Living With Limits: State and Local Finance In California," page 11.)

Counties, on the other hand, are in a different position. The major programs administered by counties are welfare, health services for the poor, and public safety. These services have little potential for fee generation. Moreover, the services that have the least ability to generate fees also have had the most explosive growth. As illustrated in Figure 2, this has resulted in a rapid growth in transfers of funds to counties from other levels of government (primarily the State) as welfare and health costs have risen. Until about 1988, however, a strong economy meant that the increase in revenues from property taxes and retail sales taxes were sufficient to meet the counties' obligations.

Figure 1



The problem for counties actually began to materialize before the recession was under way. Between 1978 and 1988, the population of California grew by 24%, but the population in poverty grew by about 40%. Beginning in 1988, even before the recession began, the population in poverty rapidly started to become a population of welfare recipients. In Los Angeles County, between 1988 and 1992, the welfare population increased by more than 50%. In addition to reduced funding from the State for these populations, the federal government also was reducing support for such costly programs as health care.

Even under normal circumstances, this rate of growth in the population needing public assistance would have been difficult to handle. State revenues from the retail sales tax that were intended to help counties fund their social welfare populations began to decline. The growth in property tax revenues began to slow. As a result, the ability of counties to fund services for the populations they are mandated to serve was severely strained. By 1995, Los Angeles County faced a budget crisis. That was simply one highly visible example of the problems facing counties throughout California.

Revenue Options for Local Governments

With the decline of the property tax as a funding

source for local governments, many jurisdictions have attempted to increase their revenues from retail sales taxes. However, retail sales have not grown rapidly, so this has not been the winning strategy that many had hoped. The reasons for the slower rate of growth for retail sales are complex and not completely understood, but what is known is that taxable sales are a declining proportion of personal income. One of the reasons this is thought to be true is because people are spending a higher proportion of their income on services rather than taxable items.

What Lies Ahead?

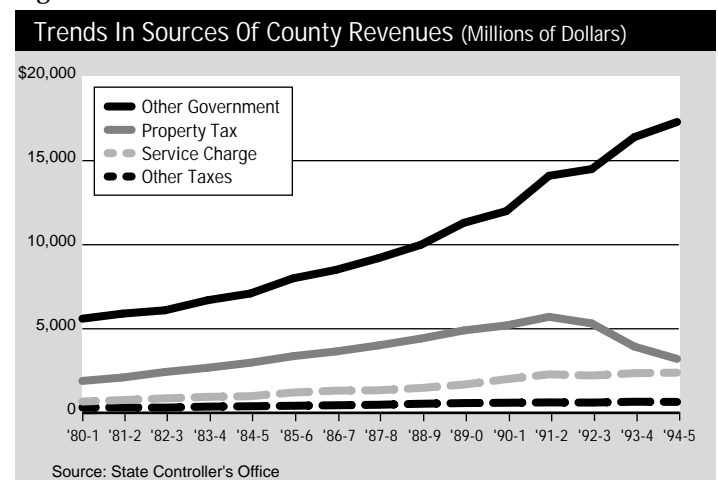
The growth of the welfare population in California certainly has contributed to the fiscal problems of counties. Welfare reform, however, is not likely to resolve these problems, at least not in the near term. Welfare reform will not eliminate poverty; counties remain the agency of last resort for people who need public assistance.

The State also has reason to be concerned about the long-term implications of the fiscal problems of local jurisdictions. Governments at the local level are responsible for a large part of California's infrastructure. Failure to maintain roads, sewers, public buildings, and other infrastructure would have a serious negative impact on California's future, economically and in terms of quality of life.

Local jurisdictions require a dependable source of funds to carry out their responsibilities. For the past two decades, the State has been an uncertain provider of these funds, responding primarily to the fiscal emergencies of local jurisdictions. Real solutions must take a longer-range view. This would include allowing local governments greater flexibility to respond to changed economic circumstances in their communities. It also may require a new division of responsibilities between the State and local governments, with corresponding authority to determine tax rates and allocations. The worst "solution" would be to continue the piecemeal approach that has marked the two decades since Prop. 13 became law.

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Figure 2



Making "Cents" of Local Dollars



By
Assemblymember
Michael Sweeney

When the deep recession hit California in the early 1990s, state income and sales taxes plummeted. The State shifted local property taxes to the State's General Fund to help pay the State's bills. Despite the fact that the recession is long over and the state is enjoying a virtual economic boom, the property tax shift from local communities to the State is still occurring.

The magnitude of this tax shift is enormous — approximately \$3.4 billion in local property tax revenues are seized from California's cities and counties every year to bail out the State General Fund. While the State's revenues are booming, many cities and counties have been forced to cut police, fire, roads, libraries, parks, and a myriad of other local services for several years in a row.

For years the State has asked local communities to make good public policy decisions. The State wants local government to approve housing that is affordable and to site manufacturing and service jobs to boost the economy. Local governments are asked to have a good jobs/housing balance so that commutes are shorter, air pollution is reduced, and open space and farmland are preserved.

Yet the State undermines these good planning decisions with its own fiscal policies. Cities and counties have little incentive to approve new housing developments, manufacturing plants, or office parks because the limited amount of property taxes that local agencies receive from these developments don't pay for the needed services.

Instead, the State encourages local communities to fight over land use and revenues. Because the State shares sales taxes with the area where a sale is made, local governments fight over auto malls and home improvement mega-stores which employ fewer well-paid workers but generate large sales tax revenues. The Wal-Marts and Home Depots have learned that it pays to pit local communities against one another. Cities scramble to offer the best sales tax givebacks. One year, two years, or more of the sales tax? No business license fees or development fees? Free roads, sidewalks, and sewer and water hookups? All this and more is on the table as each community tries to outbid the next with tax rebates and other giveaways.

This distortion of development by the State/local finance system has been termed the "fiscalization of land use." The long-term result is an imbalance between jobs and housing, longer commutes, more air pollution, and urban sprawl onto farmland and open space. It also leads to a slow decline of police and fire protection, schools, parks, libraries, and other public services that make California's communities desirable places to live and do business. In short, the distorted state-local fiscal system impedes economic development and undermines quality of life.

Reversing the property tax shift should be the first step in restoring cities and counties to fiscal health. But although I

have led the fight in the State Assembly to return local property tax revenues to California's cities and counties, I do not believe that this alone is enough. We must also repair the relationship between state government and local communities by establishing consistent and fair fiscal incentives for local agencies to do the right thing.

We should keep a few principles in mind when reforming the financial relationship between state and local governments. First, Sacramento doesn't have all the answers. We should listen to local officials who know best the needs of their communities. Secondly, where possible, one level of government should be responsible both for funding and administering any given program. This will assure both greater accountability and a better match between needs and resources.

Perhaps most importantly, state government should provide financial incentives that encourage sound land use and economic development. For example, if local governments were given a share of the income tax for every individual who both lives and works in their community, there would be a strong incentive to create well-paying jobs, adequate housing, and better schools. These kinds of fiscal incentives would assist in developing a stronger economy while reducing infrastructure needs and improving the environment.

While funding solutions to these problems will be difficult, too many California communities are suffering to allow the present situation to continue. We have a golden opportunity to make necessary changes now while our state enjoys a strong economy.

Michael Sweeney represents California's 18th Assembly District and chairs the Assembly Local Government Committee.

"Reversing the property tax shift should be the first step in restoring cities and counties to fiscal health... We must also repair the relationship between state government and local communities by establishing consistent and fair fiscal incentives for local agencies to do the right thing."

The Dual Role of County Government



By Steve Szalay
Executive Director,
California State Association
of Counties (CSAC)

County government is unlike any other level of government. Under the California Constitution, counties are subdivisions of the State. This means they are the administrative arm of the State for the delivery of services in the areas of health, welfare, courts, and jails on behalf of all county residents. At the same time, counties are also autonomous local governments which are required to provide municipal services (police, fire, lighting, sewer, parks, etc.) to the residents of the unincorporated area, and countywide services (property tax administration, animal control, weights and measures, etc.) to all residents of the county. *It is this dual role of counties that is at the root of the tension between the State and California's counties.*

Complicating the county role as hybrid provider of state and municipal services is the financing of county services. Prior to Proposition 13, local governments had exclusive control over their property taxes. The pre-Proposition 13 property tax rate was the sum of the individual rates for the county, city, school, community college, and special districts

(fire, mosquito, etc.); each component of the overall rate had a direct relationship to the amount of services it funded. Proposition 13 reduced the property tax rate from 2.5% of full cash value to 1%. Thereafter, the property taxes generated from this lower levy had to support all services provided by counties, cities, schools, and special districts. The property taxes were no longer adequate to fund local government services and there remained no practical way to increase them. The historical linkage between property taxes paid and local services provided disappeared.

Since the passage of Proposition 13 in 1978, local governments have increased their reliance upon fees to offset the cost of providing services which were previously funded from the general property taxes. The ability to generate fee-related revenue has recently been constrained with the passage of Proposition 218. This measure requires that all fees and charges that are incident to land ownership require two-thirds voter approval. The continued erosion of local discretionary revenue has disproportionately tilted services more towards that of an arm of the State at the expense of provid-

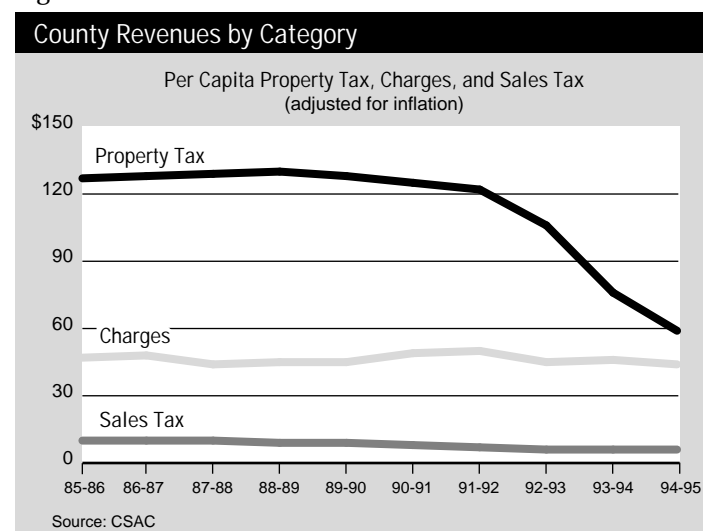
ing of municipal services in the unincorporated areas of the county.

Proposition 13 also gave the State power to allocate property taxes "by law." In fiscal years 1992-93 and 1993-94, as California was deep in recession, the State shifted property tax revenues from counties, cities, and special districts to finance schools. These two transfers of property taxes became permanent and ongoing. Counties contribute \$2.6 billion in property taxes each year for this purpose, and this amount grows as the value of property in each county increases. Even though schools have traditionally been partially financed by property taxes, school finance now blends property taxes and the State General Fund in such a way that property taxes offset the State General Fund obligation to schools.

The loss of local property taxes is the single biggest fiscal problem facing counties. This is because the obligations for counties to provide services has remained relatively constant and the demand for those services continues to grow as our population grows. As shown in Figure 1, county revenues from property tax declined for six consecutive years (from fiscal

"The loss of local property taxes is the single biggest fiscal problem facing counties... The obligation to fund programs which counties operate for the State forces counties to make cuts in the only areas they can: local discretionary programs. Consequently, cuts are being made in libraries, parks and recreation, public health and mental health systems of care, capital improvements and maintenance, property tax and fiscal systems, veterans programs, animal control, and agriculture programs."

Figure 1



“...Counties have focused on increasing sales tax revenue in reaction to the dual reality of declining property tax revenue and increasing restricted sales taxes. Consequently, the framework of local government finance skews economic development decisions more towards sales tax production and less towards a balanced approach to development that includes manufacturing and residential construction.”

year 1989-90 to fiscal year 1994-95) when adjusted for inflation and population growth. In the ten-year period since fiscal year 1985-86, the counties' property tax revenues decreased 68%.

The obligation to fund programs which counties operate for the State forces counties to make cuts in the only areas they can: local discretionary programs. Consequently, cuts are being made in libraries, parks and recreation, public health and mental health systems of care, capital improvements and maintenance, property tax and fiscal systems, veterans programs, animal control, and agriculture programs. Since property taxes represent the primary source of revenues for county discretionary programs, those programs have been vulnerable.

Fortunately, the State has provided some additional sales tax revenue to assist counties in meeting their state mandates and maintenance-of-effort requirements, although the expenditure of these new revenues has been severely restricted. For example, the State increased sales taxes by 1/2 cent in 1991 to partially pay for specific health and social service programs. Then in 1993, the

State enabled a popular vote in each county to extend the 1/2% sales tax previously approved for earthquake relief to be expended exclusively for public safety at the local level. This new revenue has been helpful, but the Board of Supervisors in each county has no discretion over how it can be expended.

All these changes have created a very complicated and fragmented system of local government revenue to fund community services. While struggling with this Byzantine system, we at the local level tend to lose sight of what should be our primary goal: to serve local residents by improving the “quality of life” in each community. Instead, we have concentrated on maintaining traditional services of established local governmental units — counties, cities, schools, and special districts — with less and very restricted revenue. The needs of our communities have taken a back seat. What we do know is that local residents tend to favor discretionary programs such as libraries, parks, public safety, transportation, and roads. These services enhance the quality of life in counties. Also, the quality of life criteria

is an integral component to county business attraction and business retention activities. Businesses prefer to operate in communities that have amenities that promote success. Business needs public safety, well-located and maintained infrastructure, affordable housing, and recreation.

To further exacerbate the problem, counties have focused on increasing sales tax revenue in reaction to the dual reality of declining property tax revenue and increasing restricted sales taxes. Consequently, the framework of local government finance skews economic development decisions more towards sales tax production and less towards a balanced approach to development that includes manufacturing and residential construction. Counties have had few good choices. They must remain financially solvent.

Unless dramatic structural changes occur in the program and financing relationship between the State and counties, the quality of life and economic development opportunities will continue to diminish for our communities.

Living With Limits: State and Local Finance in California



By Terri A. Sexton
and
Steven M. Sheffrin

The passage of Proposition 218 by the voters last November adds another layer of complexity to the state and local finance system in California. Since the passage of Proposition 13 in 1978, local governments have been constrained in their use of the traditional tax for local governments, the property tax. In the subsequent 19 years, the state and local fiscal relationship has evolved in complex ways. The property tax shift in the early 1990s further exacerbated local fiscal problems, especially for the counties. Until the passage of Proposition 218, cities were able to develop new and innovative tools to meet their financing needs. Now, they face increasing difficulties as new and increased taxes and fees will face voter approval. This paper examines the alternative sources of finance available to local government, the effects of Proposition 218, and underlying tensions remaining in the system.

After Proposition 13, local governments used a variety of different mechanisms to re-

place their loss of property tax revenues. These mechanisms included:

- **Fees and Charges**

Local governments, especially cities, scrambled to raise existing fees or enact new local levies in the wake of Proposition 13 in an effort to offset losses in property tax revenue. Most common among the new or increased levies were new building/developer fees, real estate transfer fees, new or higher business license fees, utility user fees, sewer charges, and increased park and recreation fees.

- **Property Transfer Fees**

Property transfer fees are value-based taxes on the recording, registering, and transferring of documents levied at the time of conveyance of real property from one owner to another.

- **Developer Fees and Exactions**

As a consequence of their constitutional police power to protect the public welfare, cities and counties have the authority to require developers to pay for infrastructure improvements through the dedication of land to public use, the construction of public improvements, or the payment of developer fees. Cities and counties have been increasingly conditioning the approval of development projects on the provision of a variety of public facilities, including schools, freeway interchanges, libraries, parks, public transit, fire stations, low-income housing, and childcare facilities.

- **School Impact Fees**

School districts were not granted police powers under the state constitution and consequently had to rely on

city and county governments to impose developer fees until 1986. There are limits to the fees that can be charged by school districts. However, recent court decisions have allowed cities and counties to impose additional fees beyond those imposed by school districts.

- **Benefit Assessment Districts**

Local governments have been able to establish special assessment districts since the Park and Playground Act of 1909. Since Proposition 13, their use has been expanded greatly and facilitated by a series of laws governing them. Special assessments are charges imposed on property to pay for a public improvement of direct benefit to that property. Special assessments, unlike taxes, cannot exceed the cost of providing the facility or service.

- **Increased Use of Sales Taxes**

Local jurisdictions have come to rely on sales taxes for an important part of their revenue. Since sales tax revenues are allocated to the jurisdiction in which the sale is made, there has been competition for sales-tax-rich businesses such as automobile dealerships and consumer malls.

- **Mello-Roos Bonds**

The Mello-Roos Community Facilities Act of 1982 gave counties, cities, and special districts the authority to establish community facilities districts (CFDs) within their jurisdictions. With a two-thirds approval of the district's voters, tax exempt bonds can be issued and special taxes levied. If there are fewer than 12 registered vot-

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"In our view, local government in California suffers from too little reliance on the most reliable tool for local finance: the property tax.... First, land, an essential element of the property tax base, is immobile and thus ideally suited for taxation, both from an efficiency point of view and from the perspective of the tax collector. This point has long been recognized both in economic theory and in the politics of taxation. Property taxation of structures can cause distortions as new construction does respond to taxation. But as economic growth occurs and land prices inevitably increase, the property tax is ideally positioned to absorb this increase in value."

ers residing in the CFD when it is established, approval of two-thirds of the landowners in the district is sufficient. This landowner vote provision is the feature of the Act that is primarily responsible for the rapid growth in Mello-Roos financing.

- **Tax Increment Financing**
Tax increment financing refers to the practice of issuing bonds to finance redevelopment in "blighted" areas under the premise that the redevelopment will generate enough additional property tax revenues to service the bonds. When the redevelopment agency incurs debt for a redevelopment project, the property tax base within its boundaries is frozen and the agency is subsequently entitled to the tax increment.
- **Incorporations and Annexations**
The incorporation of new cities and the extension of existing cities through annexation force a redistribution of tax revenue among local governments with city revenues increasing and county revenues declining.

Proposition 218 will limit some of these additional sources of revenues. The voter approval and other requirements of Proposition 218 will constrain the use of benefit assessment districts — a financing mechanism that had grown dramatically for cities in recent years. It also limits the use of property-based fees to services that provide direct benefit to property owners. Some analysts believe that cities will rely more on developer fees and exactions. However, development fees and exactions are also limited in scope by state law and often pit new residents against existing

residents in a community. Moreover, the development community has strongly opposed the additional fees imposed by cities and counties for school construction.

Proposition 218 has the effect of "particularizing" local finance. Each assessment or fee must stand on its own and there is less opportunity for the back-stage deal-making and trades that occurs naturally in representative bodies across issues or constituencies. Are these developments positive or negative from the point of view of economic efficiency? Whether particularization of local services is efficient depends on whether the services can be treated independently from an economic point of view. If there are no economic interdependencies (such as shared infrastructure), then it would be efficient to let each affected group make its decisions independently. But if there are important spillovers between different types of services, then these services become more like "public-goods" and some mechanism is necessary to force the voters to take into account these interdependencies.

In our view, local government in California suffers from too little reliance on the most reliable tool for local finance: the property tax. There are several reasons that the property tax is a desirable local tax. First, land, an essential element of the property tax base, is immobile and thus ideally suited for taxation, both from an efficiency point of view and from the perspective of the tax collector. This point has long been recognized both in economic theory and in the politics of taxation. Property taxation of structures can cause distortions as new construction does re-

spond to taxation. But as economic growth occurs and land prices inevitably increase, the property tax is ideally positioned to absorb this increase in value.

In California, only a relatively small percentage of property tax revenues remain with the counties or cities. For fiscal year 1995-96, the average county share of property tax revenue was 18.2% while the city share was 10.8%. Proposition 13, of course, limits the basic property tax rate as well as increases in assessed value, thereby limiting possibilities of city and county discretion for increased property tax revenue.

Second, the major alternatives to the property tax — sales and income taxes — both have flaws as local taxes. As noted above, sales taxes can promote undesirable competition between jurisdictions and distort development. Local income taxes will be limited by household mobility. If a city imposes an income tax when neighboring communities do not, it can anticipate an outflow of residents. Major employment centers can impose wage taxes (to capture commuters as well as residents) but these options are limited for smaller communities with no distinguishing or unique characteristics.

(Terri A. Sexton and Steven M. Sheffrin are coauthors, along with Arthur O'Sullivan, of "Property Taxes and Tax Revolts: The Legacy of Proposition 13" (1995). Sexton is Professor of Economics at California State University, Sacramento; Sheffrin is Professor of Economics at the University of California, Davis, and Acting Director of UCD's Institute of Government Affairs.)

Economic Profile of California's Central Valley



By Tapan Munroe
Chief Economist
and
Bill Jackman
Economist
Pacific Gas & Electric

The Central Valley economy, like the California economy, is in transition. California continues to transform itself from an aerospace giant to one of the leading knowledge- and information-based high tech economies of the world. The Central Valley is in transition from one of the leading agribusiness regions of the world to an increasingly diverse economy. Its products range from semiconductors and computers to farm and orchard products and wine.

Some 300 miles long and averaging only 50 miles in width, the Central Valley is enclosed by the Coast Range to the west and the Sierras and Cascades to the east and north. It stretches from Shasta County in the north to Kern County in the south. Many parts of the Valley continue to urbanize as growth spills over from congested and highly developed coastal regions of California. As Figure 1 shows, population growth in the Central Valley leads the state.

The Central Valley remains

the predominant agricultural producer in the United States. Six of the top ten agricultural counties in the United States are found in the Valley. Fresno County alone, the most productive one in the nation, outproduces 24 states. For the past 50 years, California has retained the nation's number-one ranking in that category, with total production reaching \$24.5 billion in 1996. This is nearly \$1 billion greater than in 1995. Two-thirds of this output was from the Central Valley.

Diversity Among Subregions

The diversity of the Valley's economy is illustrated by its three subregions: north, middle, and south. The north subregion covers the counties of Butte, Colusa, Glenn, Shasta, Sutter, Tehama, and Yuba. This area has had less development activity and is much less urbanized. It has more water and space and is not so intensively farmed. In 1996, its non-agricultural employment was 210,000 jobs.

The middle subregion covers the counties of Sacramento, San Joaquin, Solano, and Yolo. El Dorado and Placer counties, which are integral to any analysis of the Sacramento-area economy, also may be included in this subregion even though they are geographically part of the Sierra Nevada range. This entire middle portion of the Central Valley is experiencing considerable economic development as well as population spillover from the San Francisco Bay Area. There were 951,000 non-agricultural jobs in this subregion in 1996.

The south subregion includes the counties of Fresno, Kern, Kings, Madera, Merced, Stanislaus, and Tulare. This subregion, which is noted for its

intensive agriculture and oil and gas development, now has its own expanding metropolitan areas, including Bakersfield and Fresno. Non-agricultural employment in 1996 for this area was 794,000 jobs.

Post-Recession Growth

During 1990-93, the state experienced the worst recession since the Great Depression. The Los Angeles Basin was hit particularly hard. The Central Valley was barely affected by the severe downturn because of its lack of dependence on the aerospace industry as well as its strong agribusiness foundation. Had it not been for the stability and resiliency of the Central Valley's economy, the impact of the recession on the state would have been even more severe than it was.

From 1990 to 1995, the Central Valley outperformed the state in job growth in all major categories of employment, including services, government, transportation and utilities, wholesale and retail trade, fi-

Figure 1

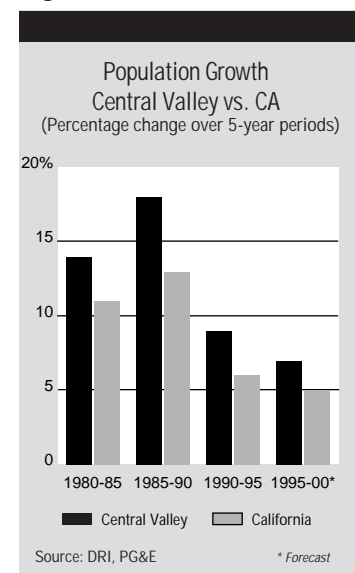
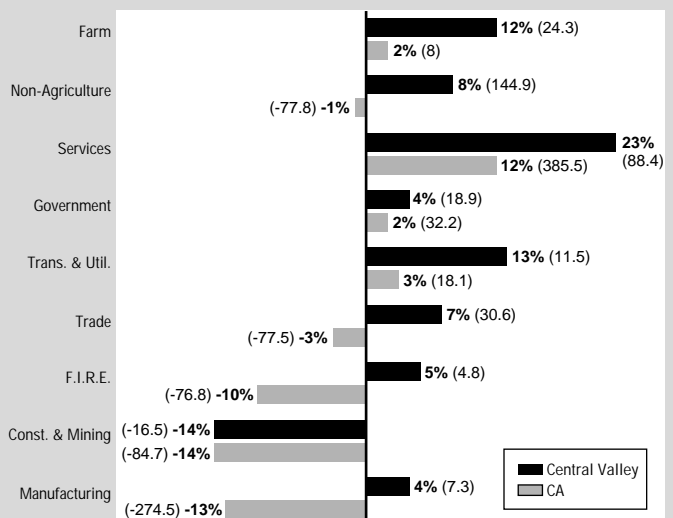


Figure 2

Employment Change by Industry, Central Valley vs. CA

(Percent change and jobs added (lost), in thousands, from 1990 to 1995)



"During 1990-93, the state experienced the worst recession since the Great Depression... The Central Valley was barely affected by the severe downturn because of its lack of dependence on the aerospace industry as well as its strong agribusiness foundation. Had it not been for the stability and resiliency of the Central Valley's economy, the impact of the recession on the state would have been even more severe than it was."

nance, insurance, real estate, and manufacturing (Figure 2).

Although the Central Valley was more resistant to the recession, it has suffered chronic high unemployment rates — on the average nearly 50% higher than the state in the past three decades. This is a result of the region's high level of agriculture-related jobs that have marked seasonal unemployment patterns. This calls for diversification of the region's economy. This is beginning to happen, particularly in the Valley's middle region. The Sacramento metropolitan area has become California's "Silicon Valley-East" with companies like Hewlett-Packard, Intel, Oracle, Packard Bell, and NEC establishing major facilities

there. The future of knowledge- and information-based industries in the entire region is promising. The proposed tenth campus of the University of California system, which would be located at Merced, will go a long way in establishing a critical knowledge infrastructure in the Central Valley's south sub-region.

Looking Ahead

The future of California lies with the Valley, as the region offers space, affordable housing, good transportation links, a good quality of life, and an increasingly diverse and sustainable economy. Along with prospects of growth in the Valley come many challenges, however, including traffic conges-

tion, pollution, land use issues (particularly the preservation of prime agricultural land), water, and the workforce needs of a 21st century economy.

We expect the Central Valley to continue to lead the other two major economic regions of California—the nine-county San Francisco Bay Area and the six-county Los Angeles region—in total non-agricultural percentage job growth during 1996-99 (Figure 3). As percentage job growth improves in the large Los Angeles area economy, however, the number of jobs added during this period will more than double that of the Bay Area or the Central Valley (Figure 4).

The future of the Central Valley is bright, as California enters the next century as one of the leading economies of the world. However, the future is "not what it used to be." It is a future where knowledge- and information-based industries will continue to diversify the region's economy. This is essential if the Valley is to be a higher wage, higher value-added economy. Even agriculture will continue to be increasingly science and technology intensive. This is essential for the region's long-term viability in a highly competitive world economy.

This article is extracted from a full report on the Central Valley economy available from PG&E in September 1997.

Figure 3

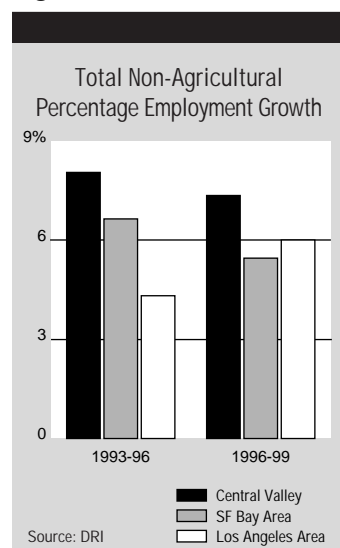
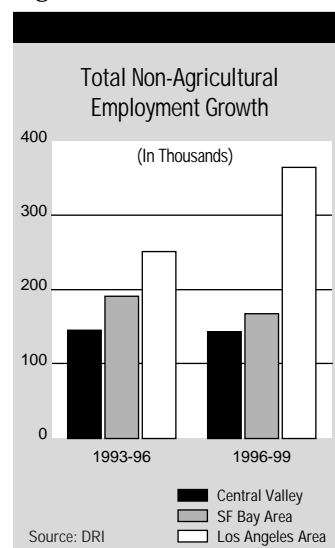


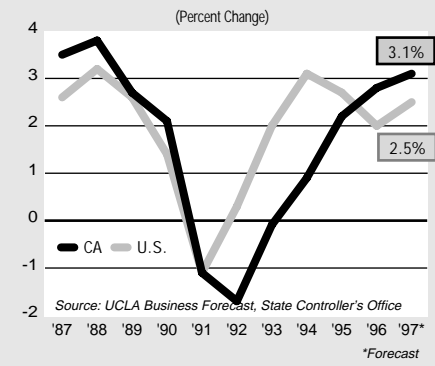
Figure 4



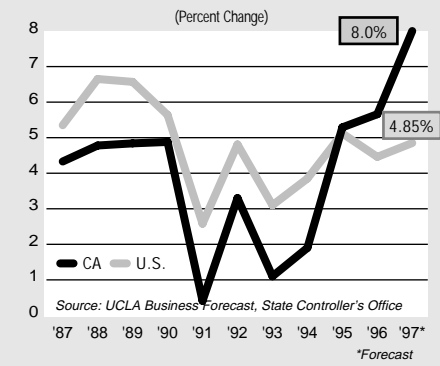
Facts and Figures

Important Information About California

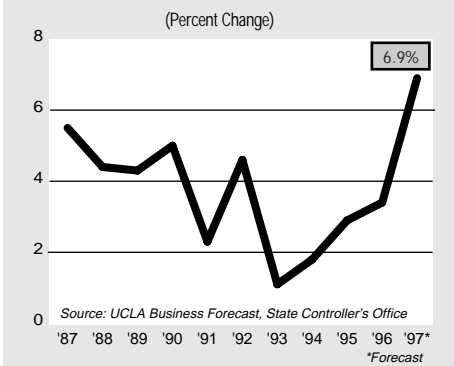
Non-farm Employment Growth, CA vs U.S.



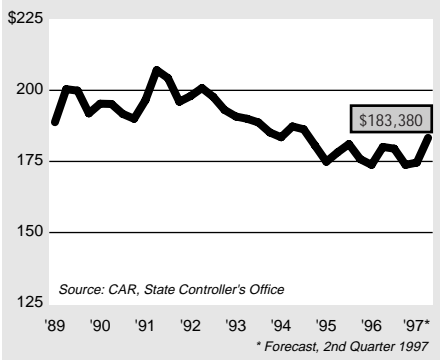
Per Capita Income Growth, CA vs U.S.



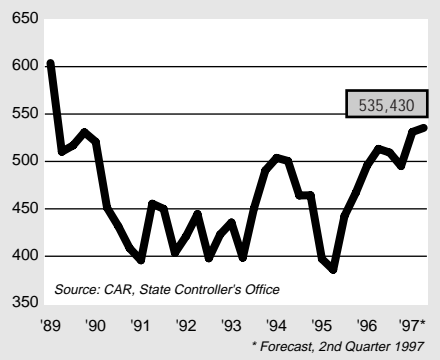
Average Annual Salary Growth, CA



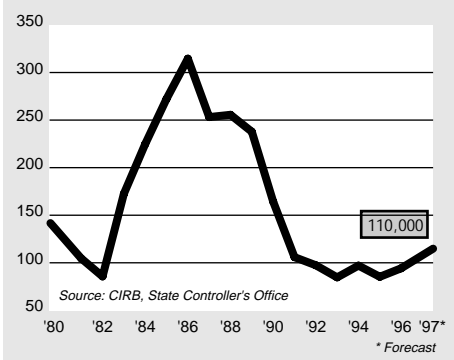
Median Home Price (In Thousands)



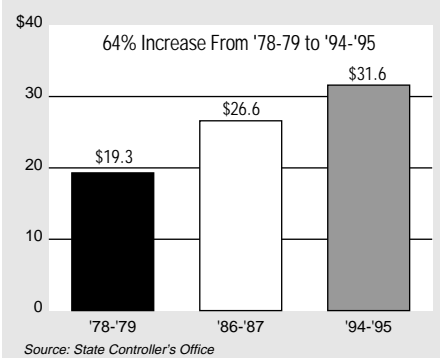
Single Family Home Sales (In Thousands)



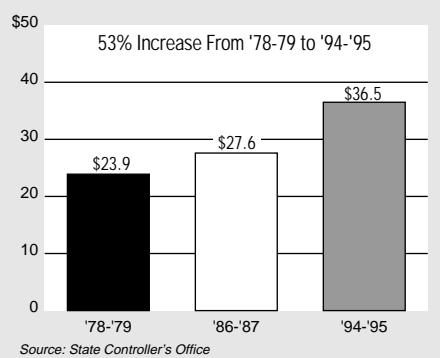
Residential Building Permits (Thousands of Units)



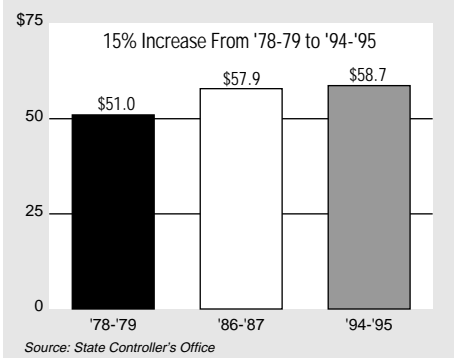
City Expenditures (In Billions)



County Expenditures (In Billions)



State Expenditures (In Billions)



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Kathleen Connell
California State Controller
P.O. Box 942850
Sacramento, CA 94250
(916) 445-2636

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